No. 97-1418

Supreme Court, U.S.
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In the Supreme Court of the United States

OCTOBER TERM, 1997

BANK OF AMERICA NATIONAL TRUST AND SAVINGS ASSOCIATION,
Successor by merger to Bank of America Illinois,
Petitioner,

v.

203 NORTH LASALLE STREET PARTNERSHIP,
Respondent.

On Petition for a Writ of Certiorari to the United States Court of Appeals for the Seventh Circuit

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REPLY BRIEF FOR PETITIONER

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REPLY BRIEF FOR PETITIONER

Nothing in the brief in opposition undermines the central points in the petition: courts are deeply divided on whether the Bankruptcy Code contains a new value exception to the absolute priority rule; the issue is of enormous practical significance in Chapter 11 cases; and a new value exception is inconsistent with the text and policies of the Bankruptcy Code. The debtor's submission does not even attempt to defend the reasoning of the panel majority. Instead, its primary thrust is that, for various reasons, this case is not an "appropriate vehicle" for addressing the existence or scope of a new value exception. Opp. 9-24. The Seventh Circuit, however, rejected all of those extraneous contentions and instead ruled directly on the question presented in the petition. As a result, this case squarely presents the issue whether there is a new value exception to the absolute priority rule, a question this Court left open in *Norwest Bank Worthington* v. *Ahlers*, 485 U.S. 197, 203 n.3 (1988), and *U.S. Bancorp Mortgage Co.* v. *Bonner Mall Partnership*, 513 U.S. 18, 20 n.1 (1994).

1. The debtor makes a half-hearted attempt to argue that there is no circuit split concerning the existence of a new value exception. Opp. 25-27. The suggestion that courts are really in agreement on this issue will surely come as a surprise to the countless judges and commentators who have recognized the sharp divisions and contentious debate that the new value exception has engendered. See Pet. 10-15. The debtor's position is also impossible to reconcile with the Second Circuit's decision in *In re Coltex Loop Central Three Partners, L.P.*, No. 96-5140, slip op. 7-8 (2d Cir. Feb. 19, 1998), which explicitly refused to follow the Seventh Circuit's decision here and the Ninth Circuit's decision in *In re Bonner Mall Partnership*, 2 F.3d 899 (1993), because "[w]e find the reasoning of the dissent in *LaSalle* * * * and the Fourth Circuit in [*In re*] *Bryson* [*Properties*, 961 F.2d 496 (1992)] * * * persuasive."

Moreover, the debtor misreads *Coltex* and *Bryson* in asserting that those decisions turned on whether "the proposed contributions of new capital had * * * been tested by the marketplace to determine whether those contributions were reasonably equivalent to the value of the interests to be retained by the old equity holders." Opp. 27. Both courts made clear that the feature of the proposed plans that violated the absolute priority rule was not the market value of the proposed contributions, but the exclusive opportunity given to prior equity holders — and no one else — to become post-petition owners of the reorganized debtor. *Bryson*, 961 F.2d at 504 (the "exclusive right to contribute constitutes 'property' * * * which was received or retained on account of a prior interest"); *Coltex*, slip op. 8-9 ("the *exclusive* right to retain the debtor's property upon making a capital contribution is itself property" that is received "on account of [the former equity holders'] former interest"). The plans at issue here and in *Bonner Mall* also gave prior equity holders the exclusive right to contribute new capital, but the Seventh and Ninth Circuits upheld confirmation of those plans, because of the new value exception. The conflict could not be more stark. The Second and Fourth Circuits would not "have confirmed the Debtor's Plan" in this case (Opp. 27) — they have held unequivocally that plans giving prior equity owners the exclusive opportunity to receive or retain an ownership interest in a reorganized debtor violate the absolute priority rule when creditors are not paid in full.

2. The conflict is also important. Most new value plans are structured just like this one: they give the prior equity holders the exclusive opportunity to contribute new capital and retain an ownership interest in the reorganized business. Pet. 11. And the negotiations that resolve most Chapter 11 proceedings will be significantly affected by even the *possibility* that a debtor will propose, and a bankruptcy court will confirm, a new value plan. Pet. 16-18. Continued uncertainty as to the existence or scope of a new value exception also drives up the cost of credit for borrowers — a point made forcefully in the *amicus* brief filed in support of the petition by the American Council of Life Insurance (at 2, 8-9).

The debtor does not take issue with any of this. Instead, it asserts that, because of two 1986 statutes, new value plans are "mere historical curiosities" that are "approaching extinction." Opp. 28-29. The debtor is wrong. Judicial and academic debate over the new value exception continues to flourish (Pet. 13-16, 25 n.12), as exemplified by the *Coltex* decision rendered just four days before the certiorari petition was filed. *Amicus* interest in the issue also continues to run high — undoubtedly because, as one recent study indicates, the confirmation prospects for new value plans have, in fact, *improved* considerably in recent years. See J. Ronald Trost, et al., *Survey of the New Value Exception to the Absolute Priority Rule and the Preliminary Problem of Classification*, SB37 ALI-ABA 595, 644 (1997) (available on Westlaw) ("Seven of the ten reported decisions since *Ahlers* [in 1988] which have actually confirmed new value plans without being subsequently reversed or vacated have been rendered since the beginning of 1995."). The increasing use of new value plans and the deepening division in the circuits combine to make the need for review by this Court even more urgent now than four years ago, when the Court granted certiorari to consider the issue in *Bonner Mall*.

The two pre-*Ahlers* statutes that the debtor cites do not support its contention that controversy over the new value exception will dissipate. Those statutes — one dealing with the taxation of real estate partnerships, the other dealing with farmer bankruptcies — hardly cover the entire range of cases in which the issue arises. Indeed, controversies over the absolute priority rule and its exceptions date back to such railroad cases as *Northern Pacific R.R.* v. *Boyd*, 228 U.S. 482 (1913), and *Kansas City Terminal R.R.* v. *Central Union*

Trust Co., 271 U.S. 445 (1926). Though it is true that real estate cases have provided a disproportionate number of the post-*Ahlers* controversies, they are hardly the only cases in which the issue can arise; as demonstrated in the petition, the issue has the potential of arising in all Chapter 11 cases involving an insolvent debtor — that is, in almost *every* Chapter 11 case. In any event, every one of those real estate controversies was litigated *after* passage of the statute the debtor cites, and they continue to be litigated today. The debtor's speculation that they will suddenly abate because of 12-year-old changes in the tax code is groundless.

3. Most of the brief in opposition (at 9-24) is devoted to arguing that the Seventh Circuit never should have reached the new value issue, because there are other grounds on which the debtor believes it should have prevailed. Even if those separate contentions had any merit — which they do not, as we explain below — they do not provide any reason to deny certiorari. The Court has long followed the rule that it is free to rule on a question as long as the court of appeals actually "'decided the substantive issue presented.'" *United States* v. *Williams*, 504 U.S. 36, 41 (1992) (quoting *Stevens* v. *Department of Treasury*, 500 U.S. 1, 8 (1991)). "'It suffices for our purposes that the court below passed on the issue presented.'" *Ibid.* (quoting *Virginia Bankshares, Inc.* v. *Sandberg*, 501 U.S. 1083, 1099 n.8 (1991)).

Thus, it does not matter whether "[t]his case *should* * * * have spawned any appellate decisions on the new value corollary." Opp. 9 (emphasis added). Because the Seventh Circuit *did* issue a decision on the new value exception, that ruling is reviewable by this Court.

4. The debtor concedes, as it must, that this case is not moot under Article III. Opp. 9 n.5. Instead, although it did not file a cross-petition, it argues that the Seventh Circuit's

judgment should have been dismissal of the Bank's appeal.[1] The debtor contends that it was imprudent for the Seventh Circuit to address the existence and scope of a new value exception in this case, because reversing the confirmation order would harm the pre-petition equity holders who contributed new capital under the plan of reorganization. Opp. 9-15.

The debtor acknowledged in the Seventh Circuit that whether to dismiss a bankruptcy appeal on prudential grounds "turns on the facts of each case." Appellee's Mem. in Support of Mot. to Dismiss, at 6.[2] The courts below examined the pertinent facts of this case, and each found that the plan could be overturned without causing harm to the debtor's investors:

- The bankruptcy court was initially "inclined to grant [a] stay" pending appeal, Tr. Dec. 4, 1995, at 7-8, but ultimately denied a stay

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[1] Because acceptance of the debtor's mootness argument would have led the Seventh Circuit to dismiss the appeal rather than adjudicate the merits, the debtor is seeking to alter the judgment below. In such circumstances, a cross-petition is necessary. *Northwest Airlines, Inc.* v. *County of Kent*, 510 U.S. 355, 364 (1994). Although jurisdictional issues generally may be raised at any time, the debtor concedes that its "mootness" argument is *not* one of jurisdiction, merely one of equity.

[2] See also, *e.g.*, *In re AOV Indus.*, 792 F.2d 1140, 1147-1148 (D.C. Cir. 1986) (deciding whether to dismiss an appeal due to "common sense or equitable considerations * * * require[s] a case-by-case judgment regarding[ ] the feasibility or futility of effective relief should a litigant prevail"); *In re Andreuccetti*, 975 F.2d 413, 418 (7th Cir. 1992) ("determining whether an appeal has become moot requires a fact-specific inquiry into the nature of the relief sought, and the effects that relief could have on the overall reorganization plan").

because "the effect of the confirmation can be fairly easily undone simply by the bank repaying to [the debtor's] investors the amount of their cash contributions," Tr. Dec. 5, 1995, at 14-15. The court reasoned that (a) this is, in essence, a "single asset real estate case," (b) the "main thrust of this plan" is "the restructuring of the financing relationship between the [debtor] and the bank," and (c) "I frankly don't see why that can't be undone in the event that the confirmation is overturned." *Id.* at 17-18.

- The district court agreed. Noting that "[t]he Confirmation Order does not involve complex transactions," the district court declined to dismiss the appeal of the confirmation order because, "in the event of reversal, the implementation of the Plan can be undone without undue difficulty and without harm to third parties." Pet. App. 60a.

- The Seventh Circuit unanimously came to the same conclusion. The court held that "[m]any of the transactions that have occurred to date easily can be reversed without significant harm to third parties" and that "if we were to reverse * * * the bankruptcy court could fashion some form of relief that would not unduly burden innocent third parties." Pet. App. 10a-11a.

These conclusions could be overturned only if the factual findings on which they are based are clearly erroneous. But this Court "do[es] not grant a certiorari to review evidence and discuss specific facts." *United States* v. *Johnston*, 268 U.S. 220, 227 (1925) (Holmes, J.). Moreover, except in "the most exceptional circumstances," this Court has a "settled practice" of "declin[ing] to review" factual findings when "the district court and the court of appeals have

concurred" in those findings. *Branti* v. *Finkel*, 445 U.S. 507, 512 n.6 (1980); accord, *e.g.*, *Exxon Co., U.S.A.* v. *Sofec, Inc.*, 116 S. Ct. 1813, 1819 (1996). That principle has even more force here — *three* levels of the judiciary have reviewed the record and agreed unanimously that the Bank could obtain effective relief should it ultimately prevail. *Pioneer Inv. Servs. Co.* v. *Brunswick Assocs. Ltd. Partnership*, 507 U.S. 380, 397 (1993) (the Court is not "inclined in any event to unsettle factual findings entered by a Bankruptcy Court and affirmed by both the District Court and Court of Appeals").

As a result, the debtor's arguments concerning the ability of the bankruptcy court to fashion effective relief are "not * * * worthy of consideration." *United States* v. *Nobles*, 422 U.S. 225, 241 n.16 (1975) ("declin[ing] to entertain" an evidentiary argument proffered as an alternative ground for affirmance). See also, *e.g.*, *District of Columbia* v. *Pace*, 320 U.S. 698, 700 (1944) ("[w]e did not take this case to determine" a factual question on which "a decision either way would be supported by substantial evidence"; the Court limited its review to a pure legal issue); *NLRB* v. *Hendricks County Rural Elec. Membership Corp.*, 454 U.S. 170, 176 n.8 (1981) (dismissing, as improvidently granted, a cross-petition that "presented primarily * * * a question of fact, which does not merit Court review").[3]

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[3] At all events, the unanimous findings by the courts below are amply supported in the record. The only "third parties" (Opp. 9) the debtor identifies — its own pre-petition investors — will not be harmed if the plan is overturned. Most significantly, the debtor does not cite, and never offered below, *any evidence* that its investors "irretrievably lost the opportunity to engage in a tax free exchange" of property as a result of the unstayed "consummation" of the Plan. Opp. 14 & n.8. In fact, the debtor's own witness

(continued...)

Finally, the debtor's contention that "[t]he very consideration of this case on its merits will cast doubt on the finality of confirmation orders" generally (Opp. 10) is preposterous. The practical effect of the debtor's position, if accepted, would be that no unstayed confirmation order, regardless of the underlying circumstances, could ever be appealed. That has never been the law. Moreover, it is not at all uncommon for courts to rule on the merits of a particular case after deciding that it is not appropriate to dismiss on equitable grounds all or part of an appeal from a confirmation order. *E.g.*, *In re Chateaugay Corp.*, 10 F.3d 944, 952-961 (2d Cir. 1993); *Andreuccetti*, 975 F.2d at 418-421; *AOV*, 792 F.2d at 1148-1154. And the debtor's reliance on Judge Easterbrook's views in making this argument (see Opp. 12) is ironic. Judge Easterbrook voted to grant rehearing *en banc* in this case (Pet. App. 49a), despite the debtor's argument that the case should be dismissed on prudential grounds.

5. The Bank's decision not to appeal the denial of its motion to terminate exclusivity (Opp. 15-17) has nothing to do with the new value issue presented here. Exclusivity refers to a debtor's exclusive right to *file* a proposed plan of

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[3] (...continued)
testified that the debtor's pre-petition partners could still offset their gains by investing in other loss-generating ventures. Tr. Dec. 5, 1995, pp. 21-29. Moreover, in its unsuccessful attempts to obtain a stay pending appeal, the Bank offered to repay the investors with interest, to "post a bond," and to use the value of its secured interest in the property to fund any shortfalls that the debtor might experience if confirmation of the plan were stayed pending appeal. Pet. App. 10a-11a; Tr. Dec. 6, 1995, pp. 17-21, 44-46. The district court thought the Bank was "offering too much," Tr. Dec. 6, 1995, p. 19, and ultimately refused to dismiss the appeal because overturning the plan would not cause "harm to third parties." Pet. App. 60a.

reorganization during the first 120 days of the Chapter 11 proceeding. 11 U.S.C. § 1121(b). Whether there is a new value exception, on the other hand, goes to whether a plan — regardless of who proposed it — may be *confirmed*. Our argument is that the *substance* of the plan here violated the absolute priority rule because it provided that only pre-petition equity holders had the opportunity to be owners of the reorganized debtor. We do not contend that the bankruptcy court violated the absolute priority rule when it denied the Bank the opportunity to file a competing plan.

6. The debtor also asserts that the absolute priority rule is not violated here, because its investors' post-petition equity interests are "worthless" and thus are not "'property' which would have been available to satisfy creditors' claims." Opp. 17. That argument is foreclosed by *Ahlers*. The Court there specifically rejected the contention that the absolute priority rule does not apply when the equity interest in the debtor is "worthless" and "has no value to the senior unsecured creditors." 485 U.S. at 207. The Court explained:

> Even where debts far exceed the current value of assets, a debtor who retains his equity interest in the enterprise retains "property." Whether the value is "present or prospective, * * * or only for purposes of control" a retained equity interest is a property interest to "which the creditors [are] entitled * * * before the stockholders [can] retain it for any purpose whatever."

Id. at 207-208 (quoting *Boyd*, 228 U.S. at 508).

Indeed, the fact that the pre-petition equity holders have "valueless partnership interests" in the debtor (Opp. 19) illustrates one of the many vices inherent in the new value exception. The new value plan here prevents the Bank from foreclosing, and thus limits the Bank's recovery to only 16% of the present value of its $38 million unsecured claim, Pet.

App. 28a, 133a — in order to perpetuate the existence of a debtor that is "worthless in a balance sheet sense." Opp. 19. This is inconsistent with the animating purpose behind Chapter 11; creditors of insolvent debtors are supposed to be in the driver's seat, not prior equity holders. *Ahlers*, 485 U.S. at 207. Chapter 11 was intended to "enabl[e] business operations that have *positive* value to carry on." *In re UNR Indus., Inc.*, 20 F.3d 766, 771 (7th Cir. 1994) (emphasis added). It was not designed to permit "valueless" (Opp. 19) business enterprises to continue in operation while the claims of senior creditors are unpaid.

CONCLUSION

The petition for a writ of certiorari should be granted.

Respectfully submitted.

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